

May 14, 1969

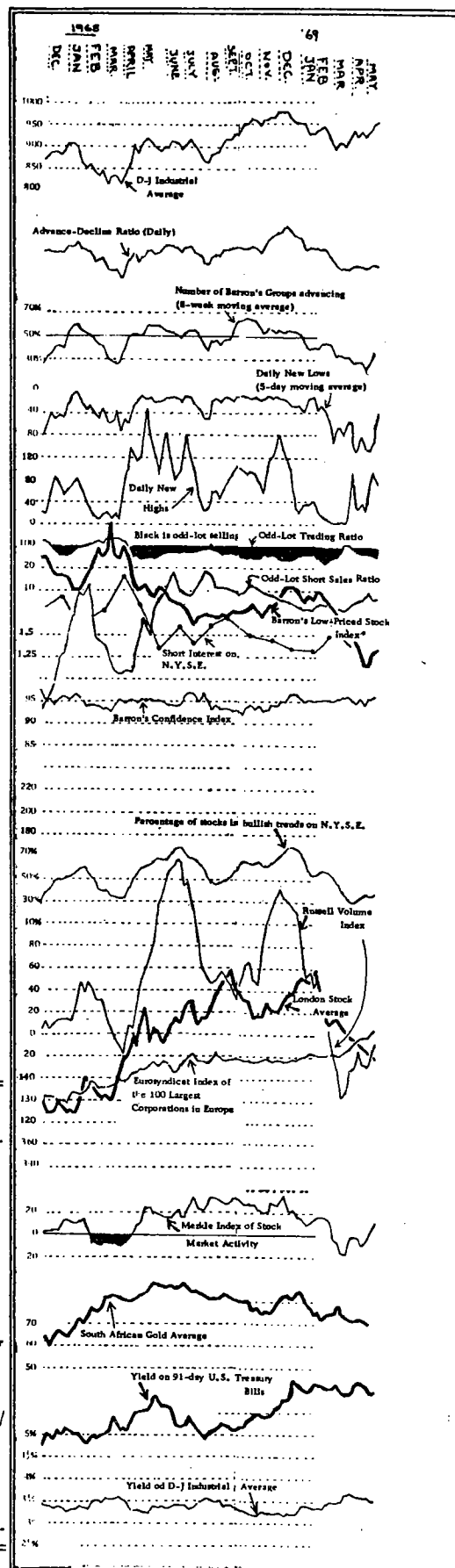
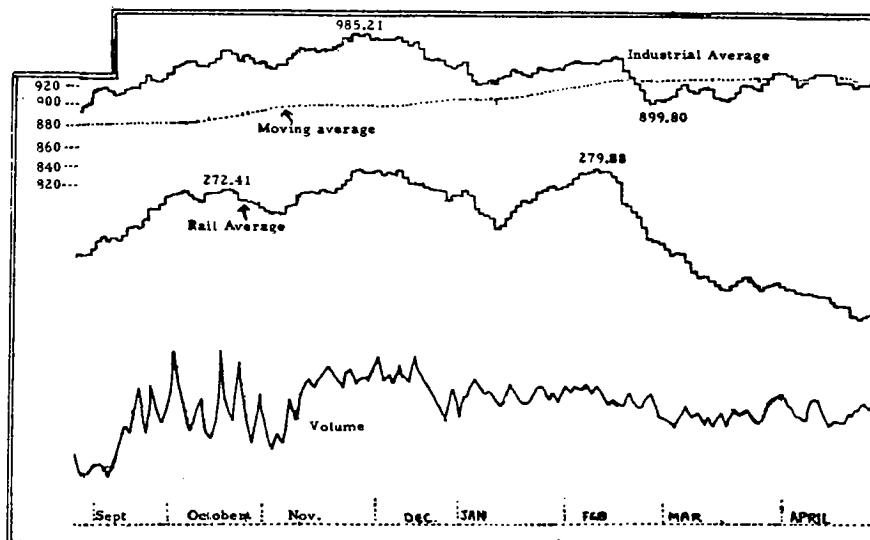
Letter 427

THE MARKET: The big news of the week was that West Germany, despite massive inflows of dollars (estimated by some at \$5 billion) has refused to re-value the mark upwards. Furthermore, in an effort to frustrate those who are hedging or speculating on a re-valued mark, the "Group of 10" (10 leading central banks) have threatened to "re-cycle" or ship out the hot money from West Germany back to the countries who have lost it in the first place. Thus, although the mark is the most wanted currency in the world today and although the mark is siphoning off speculative funds from every leading nation, the central bankers plan to send it (or loan it) back to those countries as if nothing had ever happened. It's the same old story; don't face the fundamentals, simply patch up the mess and tell yourself that you've beaten the law of supply and demand. So the tired old international monetary ship lists a few more feet towards the water-line. How long will it be before it goes under?

My own guess is that the West Germans find it politically impossible to re-value the mark and thereby take the punishment for being one of the most frugal, productive, cost conscious nations in the west. They do not want to pay the price of having their business advantage slashed just because they know how to be competitive. Furthermore, I sense that the Germans are tacitly hinting that they want a great deal more done than just a re-valuation of the mark. They want a gold price hike along with a general realignment of all currencies. The Germans are fundamentalists on money, and they do not want to take the gaff single-handedly for the inflation-bent nations' profligacy. Overhaul the whole system and the Germans will be interested. Make Germany alone pay, and they want no part of it.

Meanwhile, inflationary pressures continue to build up merrily in the U.S. Last week Treasury Secretary Kennedy stated that further monetary tightening may be necessary by autumn if things don't cool down. He added that Federal spending cuts may also be necessary in the light of steady inflationary forces.

On Wall Street the stock market has been attempting to mount a rally against a consistent background of happy business news and adverse monetary news.



Page 2 Seeming almost to reflect this schizophrenic situation, the rally has been mostly in the Dow Industrials while the Rails have lagged badly (currently they are only a few points above their 1969 low). The advance-decline ratio too has been able to rise in only token fashion, refusing persistently to confirm Industrials by bettering significant preceding rally peaks.

The incredible lack of confirmation is seen (chart on page 1) when we realize that the Industrial Average has now bettered its February 13 peak of 952.70 while Rails are a whopping 41 points below their comparable peak (the comparable Rail peak is the 279.88 peak of February 7). Thus we have a major divergence in the two leading Dow Jones Averages, and such divergences in the past have more often than not been tell-tale signs of danger in the price structure.

I continue to advocate a policy based on the fact that we are still diddling around in the "polite" or early stages of a primary bear market. You can beat the bear for a while, you can scalp and take in-and-out profits, but keep it up and the bear will claw you to death, he'll rend you when you least expect it. The policy I advocate is the policy put forth by Dow, Hamilton and Rhea. Be fully invested in a primary bull market and fully liquid in a primary bear market. Because this bear market contains many elements of a once-in-a-generation monetary fiasco. I have also advocated 10% to 15% hedge positions in leading gold shares. I haven't changed my position since the bull market topped out in February 1966. I'll probably turn rampantly bullish at the bear market bottom—when there isn't a bull around.

PRESSURE: How serious is the Federal Reserve Board about its anti-inflation program? I have been saying all along that I believe the Fed under Mr. Nixon's reign has finally become serious about stopping inflation. Business and the public, judging from the statistics, do not believe that the writing is on the wall for inflation.

In a rare (on-the-record) interview Federal Reserve Board Vice-Chairman James Robertson stated a few weeks ago: (1) Inflation cannot be fought without inflicting some economic pain, (2) Current tight money is bound to slow inflation. (3) If it doesn't, the Fed will get even tougher, (4) The use of the word "gradualism" by the Administration to describe its anti-inflation policies has not had good results. People have not taken gradualism seriously, (5) The restrictive policies of the Fed should show themselves in the economy very shortly.

Yet here are the figures. Net borrowed reserves of the member banks of the Federal Reserve system are now in the minus \$1 billion area (see chart, courtesy of Merrill Analysis, Box 225, Chappaqua, N.Y. 10514), which is a whopping minus reserve position by any reckoning. In the wake of this, last week the cost of Federal Funds went to 9.5%, highest since 1929. Federal funds measure the cost of what is paid one bank to another to make up reserve deficiencies.

Bankers' acceptances, comparable to Treasury bills but issued by the banks instead of the Government, rose to 7.25% last week. With bankers acceptances at 7.5%, along with other forms of commercial paper, it should be understood that the acceptance and commercial paper area constitutes a major vehicle for obtaining money, money which is for the most part outside the jurisdiction of the Federal Reserve. The other area for money outside the Fed system is Eurodollars or (dollars which are on deposit and available in Europe). Here too, the price has run sky high. Last week, the borrowing rate on Eurodollars reached 10%, which means that American banks were borrowing Eurodollars (if they could find them) and loaning them out at rates of 11% or higher. The U.S. Treasury itself was not without problems. Two weeks ago they made a \$6.8 billion exchange offer, including a 6.5% coupon on the new 7-year notes, the highest rate in 104 years.

Meanwhile, in Europe following DeGaulle's resignation, major currencies were caving in to new lows. In Frankfurt the dollar was smashed to a new postwar low, despite massive dollar purchases by the Bundesbank. The franc also slid to fresh lows. The pound, battered by wave after wave of selling, wobbled into low territory. Just released is the fact that during April France lost a massive \$212 million in reserves, and by all indications the movement of francs (as well as pounds and dollars) into German marks is continuing.

Most of the weakness is blamed on the huge surplus balance-of-payments position of West Germany, and as usual the cry has mounted for a re-valuation of the mark upwards. In Washington, a White House spokesman confirmed that casual meetings were being called by the President regarding the monetary situation, but Secretary of the Treasury Kennedy stated that no realignment of the international currencies was expected.

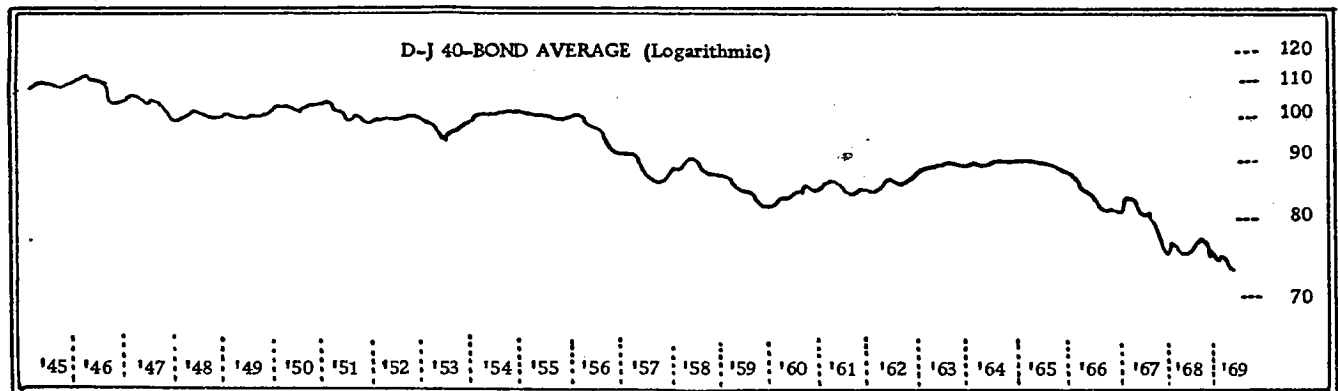
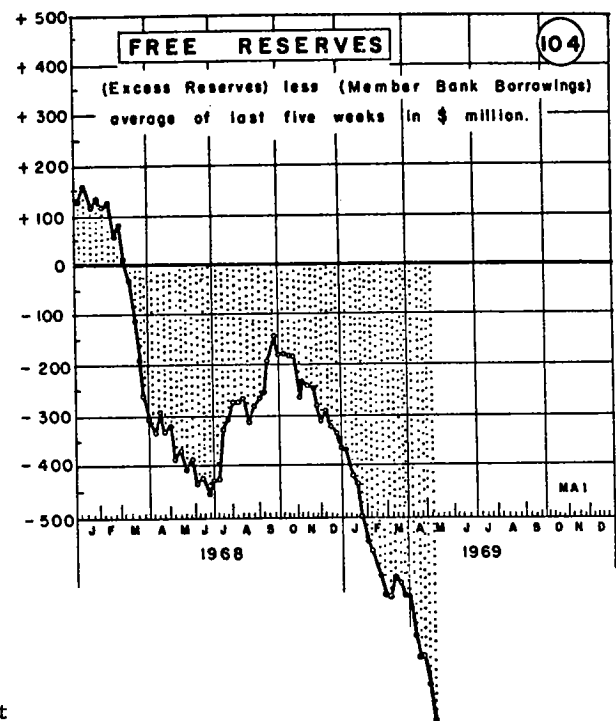
The price of gold has held close to its 1969 peak, and little cessation of this pressure can be expected in the light of the announcement a week ago that the foreign exchange reserves of 10 major European nations declined about \$3 billion in the first three months of 1969 to a nine-year low of about \$6.6 billion.

Actually, time is running out for an official solution to the international monetary mess. Little can be done until a successor to DeGaulle is elected next month. And actually, little will be done until the fall after the West German elections. The re-valuation of the mark upwards is a hotly contested political issue in Germany, with most German businessmen opposed to any re-valuation which will make German prices less competitive.

BONDS: Many subscribers write asking whether this is the time to purchase long-term bonds. Some months ago I wrote that calling the bottom in any market is difficult, and that since bonds were at 100-year bargain levels, 25% of the funds ultimately marked for bonds by individual investors could be invested.

Regarding the ultimate bottom of the bond market, I am skeptical as to whether we have seen it. The accompanying chart shows the broad D-J 40-Bond Average from 1945 to date. A major bear market began for bonds in 1946. Nothing in the chart (with the 40-Bonds now less than a point from their low of 36 years ago) suggests that the bear market for bonds is over.

One point should be made at this time. A study of bull and bear markets in bonds suggest that bull markets in bonds usually end amid some drastic series of fundamental changes. And bear markets in bonds usually terminate amid financial crises. The crisis which I expect will end this bear market in bonds has not yet broken over world markets. All the forces which have driven bonds to fantastic lows this year are still in effect. As a rule, major bottoms for bonds are associated with the collapse of an inflated credit situation and the beginning of the liquidation of credit outstanding. Those conditions have not arrived. I expect

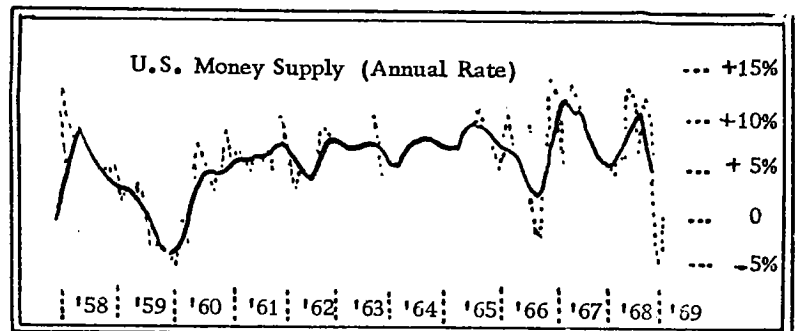


that they will. Until they do, I will continue to be skeptical as to whether bonds have touched bottom (and, of course, whether bond yields have established their ultimate highs).

I might add that a straw in the wind pointing to lower bond prices is the current rumor to the effect that the prime rate will be raised above the current 7.5% rate. Every upward pressure in key money rates means additional pressure on bonds.

MONEY SUPPLY: The famed Chicago school of economics has steadfastly maintained that the money supply in the nation is of more importance in controlling inflation or deflation than is the level of interest rates.

While there is no final answer to this argument, it is nevertheless true that the money supply in the U.S. has been pumped up massively over the past eight years. During the past two years alone the rate of expansion in the money supply was 6.5% annually.



Page 4 Now with interest rates still near 100-year highs, the money supply argument has entered the picture with a vengeance. For the first time in eight years, the money supply has turned down. During the first quarter of 1969 the decline was 3%. The decline was partly seasonal, and it was at least temporarily reversed last month. But in all it reflected the new hard policy of the Federal Reserve Board.

This chart (page 3) taken from the latest "Business Conditions Digest" put out by the Commerce Dept. shows the annual change in total U.S. Money Supply, which consists of demand deposits in the banks, currency in circulation and time deposits in the commercial banks. The heavy black line is a six-month average, the dotted line is the latest monthly figure on the money supply.

As far as money students are concerned, this is probably one of the most important charts in existence. A continued drop in the money supply would almost surely spell trouble during the period ahead. For that matter, so would a leveling off of the money supply at say a zero, or a minor 1% or 2% rate of growth.

BANK SQUEEZE: The massive pressure now bearing down on the banking system of this nation can be seen best in charts of bank liquidity. So far, a certain amount of the monetary pressure has been relieved through the mechanism of commercial paper or borrowings by individual corporations through avenues outside the U.S. banking system. A second "escape valve" has been the massive borrowing of Eurodollars by U.S. banks. Both of these sources, however, have literally reached the point of no-return.

The thing about the gathering crisis which is so ominous to this writer is that the crisis could encompass so many areas. The potential collapse could include monetary havoc, a credit and liquidity crisis, a great slide in consumer buying, and total reversal in inflation psychology, a breakdown in the gold-exchange system, a smash on Wall Street, a mountainous wave of bankruptcies, a series of social and racial upheavals, a rapid rise in unemployment, and a terrifying number of confrontations on the international front.

I would like to include a few poignant quotes from the latest issue of the authoritative Bank Credit Analyst edited by Mr. Donald Storey (1245 Sherbrooke St., West, Montreal). "They (selected monetary charts) remind us that we are somewhere near the terminal point of a once-in-a-generation super cycle when money velocity, interest rates and declining liquidity develop an exponential type of performance with the curves becoming more vertically unsustainable with the passage of time. The eventual breakdown of these curves could be a major disaster for both the stock market and business, and it seems logical that such a breakdown is more likely to happen during a period of cyclical credit contraction than during a time of rapid credit expansion such as we have witnessed since 1966."

"Short of a resolution of the gold question or a complete change of Fed policy there are few factors that will reverse the classic cyclical credit contraction that is now evolving. Super-imposed on the very long-term cycle of money and credit, the cyclical contraction could have the most eventful outcome witnessed for forty years."

The two paragraphs above provide rough summaries of the precarious banking and credit picture in the nation at this time. What about the stock market itself? To the great mass of analysts, the fact that the Dow hit a peak in February, 1966, tumbled to a 744.32 low in October, and has held ever since is an encouraging performance. "Prices have not been lower than the 1966 lows for over three years," say the optimists, "Why worry? Look at the bad news which has poured out since 1966—and still the market holds. That," they conclude, "is a mighty good performance."

I'm afraid I don't see it that way. This is the picture as I see it. The great tidal force or primary trend of the market turned down on February 9, 1966. Since then, the market has been forming the most massive, unbelievable top in the history of the Averages. For over three years the Industrials, Rails and Advance-decline ratio have been fluctuating roughly between the highs and lows established in 1966. Meanwhile, the fundamentals are turning under the market. Bank credit, interest rates, the gold situation, the social unrest, all are slowly moving to crisis levels as this market stretches out like a mighty roof over equity prices.

As a rule, the longer the market holds against the prevailing primary trend, the more violent and extended the ultimate movement in the primary direction. During the first three years of this period or during the period since 1966, instead of excesses being squeezed out of the economy, the excesses became worse. The eventual outcome, as I see it and sense it, could be a smash of almost unprecedented intensity. Every week, every month while the market holds and resists the primary bear trend, the excesses increase and the odds for disaster mount.

Often this means taking on more debt to fuel expansion. Henry Porter points out that when he arrived at General Mills six years ago debt was 23% of equity. Today it is more than 45%. Has Porter had to readjust his thinking? "No," he answers, "company performance has come closer to my thinking. With younger management coming to companies and banks and assuming continued growth in the economy," Porter adds, "I fully expect that debts of 60% to 65% of equity will be normal."

The psychology of the times is now absolutely at a peak of unreality. Debt and credit are extended to a point which would have astounded businessmen in any other era in history. I include this little clip (page 4) from the May issue of Dunn's Review, from an article entitled "The Wild Swingers of High Finance." It illustrates the type of thinking which has allowed leading corporations to extend themselves dangerously during one of the wildest periods of American financial history.

The purpose of a primary bear market is to correct the excesses of the preceding boom. As of this writing, three years after the 1966 bull market top, none of the boom excesses have been corrected. I feel that there will be hard times ahead, as the nation experiences the ultimate smash which will serve to squeeze the water out of a boom which by some reckoning began in 1942 and by other figuring began in 1949.

LAUGH CLOWN: I couldn't help laughing as I read last week's newspapers. And maybe when everything becomes so somber and hard-to-take that it seems impossible, that's what saves Americans—their great sense of humor.

THE NEW YORK TIMES, MONDAY, APRIL 21, 1969

Youth Decency Rally Turns Into Melee

BALTIMORE, April 20 (AP)—A youth decency rally attended by 40,000 persons erupted today into wild, fist-swinging mêlées among groups of youths.

Eighty-eight persons, including seven policemen, were injured, and more than 80 were arrested. The injured included several who were stabbed.

For instance, who can read this newspaper clip about a "youth decency rally" that turned into a youth riot without smiling. It's as if the "theatre of the absurd" had taken over social mores in America.

Then I read in a full page Wall Street Journal ad that Lums Inc. restaurants is teaming up with the Rowan and Martin "Laugh-in" program to produce a new franchise, the "Laugh-in Restaurant Corp." The new restaurants, the ad states, are for the millions of Americans who are "young in heart." We are told that this type of person is ready for Laugh-in, "They swing. They go places. They eat out!" True perhaps, but I'm be darned if I see why these swinging chowhounds would accept a connection between a comedy TV program and a place to dine. Could I be missing something? Anyway, for a minimum of \$34 thousand you can get a franchise and find out whether the idea has merit.

Next I read that the city of Philadelphia is actually going under financially. That if the State and the Government don't come in with fistfulls of greenbacks, Philadelphia (the city of brotherly love) will actually go bankrupt. Ten years ago I guess it would have been rather tragic, but somehow today the thought of a great American city going "to the cleaners" is simply absurd.

The final topper is avant-gard writer Norman Mailer and ex-columnist Junny Breslin running on the New York mayoralty ticket. But when you think about it, why not? Nobody else has saved New York. Maybe a little madness will bring the city back to sanity. Mailer wants statehood for New York City, and he wants to bring the Dodgers back to gotham. Asked about making marijuana legal, candidate Mailer retorted, "Hell no, I wouldn't be in favor of making it legal. You're all out of your heads. Make it legal and the cigarette companies will come in and put filter tips on your pot and vitamins and menthol in your pot. No, I say keep it criminal. There are some illegal acts which should be cherished." It should be an exciting campaign.